IT 95-54
Tax Type: INCOME TAX
Issue: Unitary Apportionment
1005 Penalty (Reasonable Cause Issue)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	)	
v.	)	Docket No.:
XXXXX	)	Hollis D. Worm
Taxpayer(s)	)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

APPEARANCES: XXXXX, for the taxpayers.

SYNOPSIS: This matter is before this administrative tribunal as the result of timely Protests and Requests for Hearing by XXXXX (hereinafter referred to as the "taxpayers") to Notices of Deficiency (hereinafter referred to as the "Notices") issued to them on February 23, 1993 and November 4, 1993. The bases of the Notices is the Illinois Department of Revenue's (hereinafter referred to as the "Department") determination that XXXXX, comprised a unitary business group during the 1989, 1990, 1991 and 1992 tax years. The Notices proposed increased tax liabilities, as well as penalties pursuant to 35 ILCS 5/1005 for failure to pay the entire tax liability by the due date.

In the taxpayers' Protests they contend that the Department's proposed finding that XXXXX, Inc. and the aforementioned companies are members of a unitary business group is totally incorrect and without merit. The Illinois Income Tax Act clearly requires an integration, dependency, and contribution among the alleged members of the unitary business group, none

of which exists in this factual situation. The issues to be resolved are:

(1). Whether XXXXX operated on a unitary basis during the 1989 through 1992 tax years?

(2). Whether penalties should be assessed pursuant to 35 ILCS 5/1005 for failure to pay the entire tax liability by the due date?

Upon consideration of all the evidence in the record, all authorities cited by the parties, and all relevant caselaw, it is being recommended that the Director of Revenue issue his Notice of Decision withdrawing the Notices of Deficiency in their entirety.

FINDINGS OF FACT:

1. On February 23, 1993 and November 4, 1993 the `Department issued Notices of Deficiency to XXXXX proposing increased tax liabilities and penalties pursuant to 35 ILCS 5/1005 for failure to pay the entire tax liability by the due date. Dept. Ex. No. 1

2. On April 20, 1993 and December 6, 1993 the taxpayers filed timely Protests and Requests for Hearing. Dept. Ex. No. 2 A formal hearing was held in this matter in Springfield, Illinois.

3. XXXXX, Inc. is in the business of leasing real and personal property. During the years in issue, it also manufactured and sold a line of air compressors used for automotive purposes. XXXXX sold its compressor product line during the summer of 1992. XXXXX is located in Illinois. Dept. Ex. No. 2

4. XXXXX is an Illinois corporation engaged in the manufacturing and distribution of football faceguards and other athletic products. XXXXX leases real and personal property from XXXXX in accordance with a lease agreement. From January, 1989 through October, 1991, XXXXX received certain computer and administrative services provided by XXXXX pursuant to a contract. Dept. Ex. No. 2

5. XXXXX is a Delaware corporation, located in Illinois, that

provides advertising and credit services.

6. XXXXX of Illinois is a Delaware corporation which is an inactive holding company. From 1989 through 1991, the only assets of XXXXX consisted of 100% of the outstanding stock of XXXXX, a Delaware corporation, and a debenture receivable from XXXXX Principal and interest on the debenture receivable were repaid to XXXXX on a monthly basis. The debenture was paid in full as of April, 1992. Dept. Ex. No. 2

7. XXXXX is a Delaware corporation which manufactures and distributes athletic protective equipment. XXXXX production facility and corporate offices are located in Tennessee. XXXXX owns 100% of the outstanding stock of XXXXX Dept. Ex. No. 2

8. With the exception of advertising and credit services provided by XXXXX, the management of XXXXX is directed by the company's management team which, from 1989 through 1991, consisted of certain key people in Tenessee. The company's production, purchasing, planning, shipping, sales, financing, research and product development, quality control, accounting, personnel, union negotiations and other vital functions were all performed on an independent basis at the Tennessee plant, supervised by the company's management team. Dept. Ex. No. 2

9. XXXXX, Inc., XXXXX and XXXXX filed their Illinois income tax returns on a separate return basis during the tax years in issue.

10. The taxpayers are a group of persons related through common ownership. Tr. p. 69

CONCLUSIONS OF LAW:

Issue (1): Whether XXXXX, Inc., XXXXX Com., XXXXX, XXXXX of Illinois and XXXXX operated on a unitary basis during the 1989 through 1992 tax years?

35 ILCS 5/1501(a)(27) defines a unitary business group as:

> . . . a group of persons related through common ownership whose business activities are integrated

with, dependent upon and contribute to each other.

The unitary business concept had developed as a balance between a taxing state addressing the economic realities of a given corporate structure and the federal constitutional parameters regarding taxation of interstate activity. The United States Supreme Court has long sanctioned the unitary business principal Mobil Oil Corp. v. Commissioner of Taxes of Vermont, (1980) 445 U.S. 425, 100 S. Ct. 1223, 63 L. Ed. 2d 510, as well as the necessarily resulting apportionment of income generated by the unitary group to a taxing state as determined by a statutory formula.

The unitary concept is a prime example of substance over form in the area of taxation. As the Illinois Supreme Court stated in Caterpillar Tractor Co. v. Lenckos, et. al.(1981) 84 Ill. 2d 102, 417 N.E. 2d 800, 156 Ill. Dec. 329: "[a] unitary business operation is one which there is a high degree of interrelation and interdependence" between a corporation, its subsidiaries, and affiliated corporations. Thus a "unitary business group" is defined in terms of integration, dependence, and contribution. The Illinois statutory scheme provides that

> [u]nitary business activity can ordinarily be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining, and marketing); and, in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member). 35 ILCS 5/1501 (a)(27).

The taxpayers do not dispute that they are a group of persons related through common ownership. With respect to the corporations being in the "same general line" or "steps in a vertically structured enterprise or process", because of my determination that they are not functionally

integrated through the exercise of strong centralized management, a finding on either of these requirements is rendered irrelevant.

86 Ill. Adm. Code, Ch. I, Section 100.9900(g) states the following:

> [N]o group of persons can be a unitary business group unless they are functionally integrated through the exercise of strong centralized management. It is the exercise of strong centralized management that is the primary indicator of mutual dependency, mutual contribution and mutual integration between persons that is necessary to constitute them members of the same unitary business group. The exercise of strong centralized management will be deemed to exist where authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member...

The regulation further provides that a finding of "strong centralized management" cannot be supported by showing that the requisite ownership percentage exists or that there is some incidental economic benefit accruing to a group because such ownership improves its financial position. It is the actual exercise of such strong centralized management that is significant.

The record lacks evidence of the crucial element of the exercise of strong centralized management. XXXXX did provide some computer and administrative services and leased real and personal property to XXXXX, and XXXXX did provide some advertising and credit services to XXXXX, but these are not the types of authoritative oversight activities described in the regulation as indicative of the exercise of strong centralized management.

In ASARCO v. Idaho State Tax Commission (1982) 458 U.S. 307, 102 S. Ct. 3103, 73 L. Ed. 2d 787, the parent corporation owned over fifty percent of an Australian corporation (M.I.M.) engaged in similar mining-related activity. The United States Supreme Court found that:

> [a]lthough ASARCO has the control potential of manage M.I.M., no claim is made that it has done so. As an ASARCO executive explained, it never even elected a member of M.I.M.'s board. . . . In addition to forgoing its right to elect directors, ASARCO similarly has taken no part in the selection of M.I.M.'s officers -- a function of the Board of Directors. Nor do the

> two companies have common directors or officers. The [Idaho] state trial court found that M.I.M. "operates entirely independently of and has minimal contact with" ASARCO. As the business relation is also minimal, it is clear that M.I.M. is merely an investment.

The ASARCO Court found facts establishing the simple investor-investment relationship. Similarly, in F.W. Woolworth Co. v. Taxation and Revenue Department, (1982) 458 U.S. 354, 102 S. CT. 3128, 73 L. Ed. 2d 819 argued and decided together with ASARCO, the Court reiterated the necessity of actual, practical interdependence:

> [New Mexico] state court's reasoning would trivialize this due process limitation by holding it satisfied if the income in question "adds to the riches of the corporation. . . ." Income from whatever source, always is a "business advantage" to a corporation. Our own cases demand more. In particular, they specify that the proper inquiry looks to "the underlying unity or diversity of business enterprise."

Accordingly, pursuant to parameters set forth by the United States Supreme Court, as well as the Department's own regulation, XXXXX, Inc., XXXXX, XXXXX, XXXXX of Illinois and XXXXX do not meet the test of being functionally integrated through the exercise of strong centralized management.

Issue (2): Whether penalties should be assessed pursuant to 35 ILCS 5/1005 for failure to pay the entire tax liability by the due date?

Having determined that the taxpayers did not comprise a unitary business group during the 1989 through 1992 tax years, there is no additional tax due the State of Illinois and no penalty to be assessed pursuant to 35 ILCS 5/1005.

Therefore, it is my recommendation that the Director of Revenue issue his Notice of Decision withdrawing the Notice of Deficiency in its entirety.

Hollis D. Worm
Administrative Law Judge

July 21, 1995